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dissatisfaction with the present escrow account system can be achieved through the elimination of such hidden charges coupled with legislative requirements that mortgagors be credited in some manner with the profits derived from the investment of their escrowed funds.

MICHAEL E. KAEMMERER

TAXATION—ACCUMULATED EARNINGS TAX NOT APPLICABLE TO A PUBLICLY HELD CORPORATION

*Golconda Mining Corp. v. Commissioner*¹

Section 531 of the Internal Revenue Code of 1954 imposes a tax on earnings which a corporation unreasonably accumulates instead of distributing as dividends.² The purpose of the tax is to discourage the use of a corporation as a tax shelter for individual shareholders—*e.g.*, where it would be advantageous for the shareholder to have earnings disbursed at a later date when tax conditions are more favorable to him. The purpose of the tax is to deter tax avoidance by the shareholders of a corporation, rather than any avoidance by the corporation itself. The more independent management is from one or a few of the shareholders, the less likely it is that the corporation will retain its earnings for the tax benefit of individual shareholders. Thus, the likelihood of the accumulated earnings tax being imposed is greatest where a single group of shareholders has effective control over corporate dividend policy.³ On the other hand, a corporation with a large number of shareholders and independent management would have little reason to fear imposition of the tax.⁴

The Commissioner has generally assessed the tax only against closely held corporations,⁵ although there is no specific statutory provision making a distinction between closely held and publicly held corporations.⁶

1. 507 F.2d 594 (9th Cir. 1974), *rev'g* 58 T.C. 139 (1972).

2. "In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income . . . an accumulated earnings tax. . . ." INT. REV. CODE OF 1954, § 531.

3. For an interesting side effect, see Barker, *The Accumulated Earnings Tax as a Deterrent to Business Diversification of Close Corporations*, 16 KAN. L. REV. 98, 103 (1967), where it is pointed out that small closely held corporations are deterred from retaining funds in preparation for expansion into a different area of business due to fear of the accumulated earnings tax and a statutory presumption that these funds are being accumulated for the purposes of avoiding income tax.

4. See note 7 *infra*. See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 8.02 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

5. Robson, *Corporate Liquidity, Reserves, and the Accumulated Earnings Tax*, 51 N. CAR. L. REV. 81, 82, n.6 (1972).

6. INT. REV. CODE OF 1954, § 532(a) provides:

General Rule—The accumulated earnings tax imposed by Section

Stockholder pressure in a publicly held corporation, including potential shareholder derivative actions, is usually an even greater incentive for management to declare dividends than the tax imposed by section 531.⁷ On at least one occasion, however, the government has attempted to impose the tax on a corporation with relatively broad ownership.⁸ The application of the tax to a corporation with a large number of shareholders is an issue which has troubled the business world⁹ and which had not been confronted under the 1954 Code prior to *Golconda*.

Golconda Mining Corporation was a publicly held Idaho corporation. During the years in issue, it had from 1,500 to 2,900 shareholders and the management group owned or controlled no more than 12 to 17 percent of its stock.¹⁰ *Golconda* was assessed with the accumulated earnings tax for the years 1962 through 1966. The Tax Court found that for the years 1962 through 1965 *Golconda* did not accumulate its earnings beyond the reasonable needs of its business. For the year 1966, however, *Golconda* failed to establish by a preponderance of the evidence that its accumulation was not for avoidance of income tax. The Tax Court held, therefore, that *Golconda* was subject to the accumulated earnings tax.¹¹

The threshold question that the Tax Court faced in *Golconda* was whether the accumulated earnings tax could be assessed against a publicly held corporation.¹² The Tax Court looked at the manner in which the company was managed to negate public ownership.¹³ Then, in reliance on the *Trico Products* cases,¹⁴ decided under the 1939 Code, the Tax Court held that the tax was applicable.¹⁵ The Court of Appeals for the Ninth Circuit reversed, holding that the accumulated earnings tax does not apply to publicly held corporations.¹⁶ Subsequently, the Internal Revenue Service

531 shall apply to *every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed* (emphasis added).

7. BITTKER & EUSTICE, *supra* note 4, ¶ 8.02, at 8-6; Whitmore, *The Accumulated Earnings Tax: Where We Are—Major Developments 1965-1966*, 16 TUL. TAX INST. 230, 232 (1966) [hereinafter cited as Whitmore].

8. There has been only one instance since adoption of the 1913 Revenue Act, aside from *Golconda*. *Trico Prod. Corp. v. McGowan*, 169 F.2d 343 (2d Cir.), *cert. den.*, 335 U.S. 899 (1948); *Trico Prod. Corp. v. Comm'r*, 137 F.2d 424 (2d Cir.), *cert. den.*, 320 U.S. 799 (1943). See text accompanying notes 23-24 *infra*. See generally 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 39.54 (1967 rev'n).

9. See, e.g., Davison & Davis, *Golconda Mining Corp. Forebodes 531 Attacks on Publicly Held Corporations*, 51 TAXES 371, 378 (1973).

10. *Golconda Mining Corp. v. Comm'r*, 58 T.C. 139, 158 (1972).

11. *Id.* at 157.

12. *Id.*

13. See note 21 and accompanying text, *infra*.

14. *Trico Prod. Corp. v. McGowan*, 169 F.2d 343 (2d Cir.), *cert. den.*, 335 U.S. 899 (1948); *Trico Prod. Corp. v. Comm'r*, 137 F.2d 424 (2d Cir.), *cert. den.*, 320 U.S. 799 (1943).

15. *Golconda Mining Corp. v. Comm'r*, 58 T.C. 139, 159 (1972).

16. 507 F.2d at 597.

issued a non-acquiescence bulletin stating that it does not accept the court of appeals' decision in *Golconda*.¹⁷

The decision of the court of appeals in *Golconda* makes the determination whether a corporation is publicly held a critical issue in cases involving the imposition of the accumulated earnings tax. Corporations with a large number of shareholders, such as *Golconda*, undoubtedly need to know if they will be considered publicly held and thereby avoid the application of the accumulated earnings tax.¹⁸ Unfortunately, the court of appeals' decision in *Golconda* does not specify what factors a court should consider in making the determination whether a corporation is publicly held for purposes of the accumulated earnings tax. The case is subject to three different interpretations¹⁹ with respect to how this determination is to be made.

First, *Golconda* could be narrowly read on its facts as simply saying that a corporation like *Golconda* is a publicly held corporation, and therefore the tax is not applicable. Under this view, the predominant guideline in the field would be a series of cases which arose in the 1940's involving the Trico Products Corporation.²⁰ Until *Golconda*, these cases had been the only instances of application of the tax to a publicly held corporation (approximately 2,200 stockholders). Under this approach, corporations with a large number of shareholders may be found to be not publicly held, and thus subject to the accumulated earnings tax. In *Golconda*, the Tax Court looked at the manner in which the company had been managed to override the fact that the corporation was owned by many shareholders.²¹ Notwithstanding reversal of the Tax Court on appeal, it is arguable that, under a narrow reading of the court of appeals' opinion in *Golconda*, courts will still examine the manner in which a corporation is managed to decide the threshold question whether the corporation is publicly held for purposes of the accumulated earnings tax.²²

17. Rev. Rul. 75-305, 1975 INT. REV. BULL. No. 30 at 12.

18. For example, to decide if they can safely retain funds in preparation for expansion into a different area of business. See note 3, *supra*.

19. A fourth possible interpretation may exist. A specific statutory exception for publicly held corporations was offered by the House of Representatives in the enactment of the 1954 Code. It would have excluded all corporations which could produce records showing that no more than 10 percent of its stock was held by one family. H. R. REP. NO. 8300, 83d Cong., 2d Sess. § 532 (1954). This provision was rejected by the Senate because of the difficulty of proof a corporation would have, considering the type of records which would have to be produced. S. REP. NO. 1622, 83d Cong., 2d Sess. 69 (1954). It can be argued that this was an implicit adoption of the House standard, but a rejection of the stringent proof requirement.

20. *Trico Prod. Corp. v. McGowan*, 169 F.2d 343 (2d Cir.), *cert. den.*, 335 U.S. 899 (1948); *Trico Prod. Corp. v. Comm'r*, 137 F.2d 424 (2d Cir.), *cert. den.*, 320 U.S. 799 (1943).

21. We are mindful, however, that the imposition of this tax upon a publicly held company should only occur where the fact of public ownership is neutralized by the manner in which the company has been managed. 58 T.C. at 158.

22. Cf. BITTKER & EUSTICE, *supra* note 4, ¶ 8.02, at 8-5, 8-6, where it is stated

The second possible approach is to limit *Trico* to its facts and treat *Golconda* as setting forth the general rule that almost all widely held corporations will be found to be publicly held and thereby avoid imposition of the accumulated earnings tax. This interpretation is supported by several factors. First, *Trico* dealt with an unusual set of facts. A group of 21 shareholders held between 62 and 68 percent of the company's total shares, either directly or indirectly through ownership of 85 percent of a holding company which in turn owned 55 percent of *Trico*'s stock. Three-quarters of *Trico*'s shareholders were substantially benefited by its accumulation of earnings and over \$3,000,000 in personal income taxes were avoided.²³ Second, although the court of appeals in *Golconda* recognized *Trico* without overruling it, it specifically pointed out that *Trico* should not be relied upon because of its unusual facts.²⁴ Third, nearly 30 years passed between *Trico* and *Golconda* without any other cases allowing the accumulated earnings tax to be assessed against a publicly held corporation. Under this second interpretation, courts would not examine the manner in which a corporation is managed to negate the fact that the corporation is owned by many shareholders. Obviously, such an approach would be advantageous to the corporation involved.

The final interpretation is based on the legislative history of section 531. In enacting the 1954 Code the Senate rejected a proposed House exclusion for publicly held corporations, but it did recognize that "as a practical matter, the provision has been applied only in cases where 50 percent or more of the stock of a corporation is held by a limited group."²⁵ The court of appeals pointed out that this recognition takes on special meaning when coupled with the rule that treasury interpretations long continued without substantial change, applying to substantially reenacted statutes, are deemed to have received congressional approval and to have the effect of law.²⁶ Under this rationale, the standard would appear to be absolute; however, a counterargument rests on Senate recognition that the tax was *theoretically applicable* to publicly held, as well as closely held, corporations.²⁷ The Tax Court in *Golconda* had relied on this "theoretically applicable" language to conclude "as a matter of law that the ac-

that publicly held corporations have little to fear if management is independent and not under the domination of a few large shareholders, and if individual stockholdings are sufficiently diffused so that no single group can effectively control corporate dividend policy. See also Whitmore, *supra* note 7, at 233.

23. "In the *Trico* cases six men dominated the operation of the company and . . . avoided personal income taxes of \$3,085,000." Tierney & Trokko, *Tax Court's Golconda Mining Decision: What Are Its Implications in the 531 Area?*, 32 J. TAX. 290, 291 (1972).

24. 507 F.2d at 596.

25. S. REP. NO. 1622, 83d Cong., 2d Sess. 69 (1954). The House also recognized this and further stated "the area of tax avoidance through a retention of corporate earnings is confined to closely held companies." H. R. REP. NO. 1337, 83d Cong., 2d Sess. 54 (1954).

26. *Helvering v. Winnmill*, 305 U.S. 79, 83 (1938).

27. S. REP. NO. 1622, 83d Cong., 2d Sess. 68 (1954).